

## 3. The fiscal rules and policy framework

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### Summary

- Designing fiscal rules requires a trade-off between precision on the one hand and simplicity and transparency on the other. The golden rule and sustainable investment rule are not optimal as currently applied and could be improved. But they still have significant potential value as rules of thumb.
- Many economists outside government no longer see compliance with the fiscal rules as a good guide to the health of the public finances. In part this reflects concern that Gordon Brown, when Chancellor, 'moved the goalposts' to make the golden rule easier to meet.
- Using the Treasury's start and end dates for economic cycles, it met the golden rule over the previous economic cycle with £19 billion to spare and appears on course to meet it over the new cycle, provided the cycle is sufficiently long. However, using other plausible methods to date the cycle, the golden rule has already been broken under Labour.
- It would be sensible to make the golden rule symmetric, forward-looking and less reliant on the need to date the economic cycle precisely. The Treasury's fiscal forecasting could be made more transparent or perhaps even delegated to an independent body.
- There seems to be no appetite among the main political parties to reduce the burden of public sector debt significantly. But most industrial countries have done more to reduce their debt since 1997 than the UK and more than one in three OECD countries now have net holdings of financial assets rather than net debt.
- The taxpayer has provided guarantees worth up to £55 billion to Northern Rock's creditors. But if Northern Rock is nationalised, or if the Office for National Statistics determines that the government is in effective control of the company, around £100 billion could be added to public sector net debt.
- Were this to occur, the government should be able to unwind most (or perhaps even all) of the increase once Northern Rock's mortgage book has been sold. Whether a fiscal policy response is required should be determined by the long-term impact on public sector net debt rather than any short-term impact. Meanwhile, the Treasury should present public sector net debt figures including and excluding the impact of commitments made to Northern Rock.

### 3.1 Introduction

As we explained in Chapter 2, whilst in opposition the then Shadow Chancellor of the Exchequer Gordon Brown wanted to persuade voters that he would be a fair and prudent

steward of the public finances. He saw a commitment to broad objectives for fiscal policy, operationalised through specific fiscal rules against which performance could be judged, as the best way to achieve this. The two specific rules that he adopted were the golden rule and the sustainable investment rule:

- The **golden rule** requires the public sector to borrow only what it needs to pay for capital investment, and to finance its remaining current spending from tax and other revenues. In other words, the government has to keep the current budget (revenues minus current spending) in balance or in surplus. The rule has to be met on average over the ups and downs of the economic cycle rather than every year.
- The **sustainable investment rule** requires the government to keep the public sector's debt (net of its short-term financial assets) at a 'stable and prudent' level. The Treasury has defined this as less than 40% of national income (GDP) at the end of every financial year of the economic cycle that it currently estimates ran from the first half of 1997 to the end of 2006. Despite the fact that the Treasury's forecasts suggest (and Gordon Brown has explicitly stated<sup>1</sup>) that a new economic cycle has already begun, the Treasury has not yet announced how 'stable and prudent' is to be defined over this or future cycles.

The government formally adopted these rules in the 1998 Finance Act. The Act also placed the rules in a statutory framework, a 'Code for Fiscal Stability' that requires governments to spell out how they intend to formulate and implement fiscal policy and how they propose to manage the national debt. The Code also requires them to publish biannual forecasts demonstrating how policy at any given time is consistent with their chosen approach.

But the Code leaves the government to decide whether or not to set itself any operating rules and, if it does, to judge itself whether or not those rules have been adhered to. There is no penalty, other than potential reaction of voters and financial market participants, if they are missed.<sup>2</sup> This has contributed to suspicions that the government has applied the rules in such a way as to make them easier to meet while avoiding having to make painful policy adjustments at politically inconvenient times. This in turn has prompted calls for greater independence in judging adherence to the rules so that the Treasury no longer 'marks its own exam paper'.

This chapter describes the fiscal rules, assesses their operation to date and highlights ways in which assessment of adherence to them could be improved further. Section 3.2 examines the golden rule and Section 3.3 the sustainable investment rule. In Section 3.4, we describe a set of reforms that would improve the operation of the rules and might also help restore confidence that they truly reflect the underlying principles that inspired them.

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<sup>1</sup> G. Brown, interview, *The Andrew Marr Show*, British Broadcasting Corporation, 6 January 2008 ([http://news.bbc.co.uk/1/hi/programmes/andrew\\_marr\\_show/7173794.stm](http://news.bbc.co.uk/1/hi/programmes/andrew_marr_show/7173794.stm)): 'I believe the fiscal arithmetic will prove over the cycle to be fine. The golden rule is something that is over the economic cycle.... We have just finished one economic cycle where we have met the golden rule, well that will be assessed in the Budget, of course. We are starting a new economic cycle and the question is over the whole years of the economic cycle do you have what is called a current balance.'

<sup>2</sup> For a detailed discussion, see C. Emmerson, C. Frayne and S. Love, 'Updating the UK's Code for Fiscal Stability', IFS Working Paper W04/29, 2004 ([http://www.ifs.org.uk/publications.php?publication\\_id=3163](http://www.ifs.org.uk/publications.php?publication_id=3163)).

## 3.2 The golden rule

The golden rule is designed to help achieve intergenerational fairness by ensuring that future taxpayers are not left to pay for public spending from which all the benefits have accrued to the current generation. It is also intended to remove a possible bias against investment if and when public spending has to be restrained. In such a situation, it might be more tempting to cut capital rather than current spending because it normally takes longer for voters to feel the effects of cuts in capital spending on the quality of public services.<sup>3</sup> Requiring that the golden rule be met only on average over the economic cycle, rather than (for example) every financial year, allows fiscal policy to ‘support monetary policy’ – i.e. it makes it less likely that fiscal policy will have to be tightened at the same time as monetary policy is loosened (not that this is necessarily always undesirable).<sup>4</sup>

In the next two sections, we focus on two questions that arise in relation to the objectives of the golden rule:

- Does allowing the government to borrow only to finance capital investment in fact achieve intergenerational fairness?
- Is it sensible to seek to apply the rule over an economic cycle with specific start and end dates?

We then examine how the golden rule has been applied in practice and whether the Treasury’s latest forecasts suggest it has been and will be met over the economic cycles since Labour came to power in May 1997.

### Intergenerational fairness

For a number of reasons, balancing the current budget as defined for the purposes of the golden rule will not necessarily achieve intergenerational fairness:

- The golden rule is based on the distinction between capital and current spending used in the National Accounts, which is in turn based on international accounting standards as interpreted by the Office for National Statistics. These accounting definitions do not necessarily coincide with spending that does and does not benefit future taxpayers. For example, spending on the enhancement of skills might increase future economic growth but does not score as capital spending: £1 of ‘current’ spending on the training of teachers or doctors might benefit future taxpayers more than £1 of ‘capital’ spending on an Olympic venue of uncertain long-term use.

The unfunded nature of many public sector pension arrangements – such as those covering many teachers, doctors, nurses, police, firefighters, civil servants and MPs – means that a significant part of the remuneration package for these workers will only

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<sup>3</sup> For a discussion, see HM Treasury, *Fiscal Policy: Current and Capital Spending*, London, 1998 (<http://www.hm-treasury.gov.uk/media/8/5/530.pdf>).

<sup>4</sup> The extent to which fiscal policy has been ‘coordinated’ with monetary policy since 1997 is discussed in section 2.7 of R. Chote, C. Emmerson, A. Leicester and D. Miles (eds), *The IFS Green Budget: January 2007*, IFS Commentary 102, January 2007 (<http://www.ifs.org.uk/budgets/gb2007/index.php>).

count as current expenditure once their pension is in payment. The principle underpinning the golden rule implies that, to the extent to which the services these public sector workers provide benefit the current generation, their remuneration costs should be met by current taxpayers. While current taxpayers are financing the unfunded public sector pensions of former public sector employees, despite the fact that they did not necessarily benefit from the services they provided, these payments are expected to be lower than the cost of unfunded commitments accruing to current public sector workers. The scale of these liabilities is discussed in more detail in Section 3.3.

The Chancellor could distinguish spending that may and may not be covered by borrowing in a more sophisticated way, but there is likely to be a trade-off between the richness of the rule and its transparency. As Treasury officials have argued, 'It is difficult to agree on a robust definition of growth enhancing expenditure once generally accepted accounting standards are departed from'.<sup>5</sup> Observers might well suspect that a bespoke definition could be tweaked and spending reclassified if and when a breach of the rule looked likely. Even with the use of the National Accounts definitions, the current government has sometimes been accused of reclassifying current spending to ease the constraint of the golden rule.<sup>6</sup>

- To judge rigorously whether or not tax and spending decisions are intergenerationally fair, one would need to consider the overall impact of taxes and spending and take a 'general equilibrium' approach, analysing their knock-on impact throughout the economy and not just the formal incidence of a few policy instruments taken in isolation. One would need to understand who ultimately bears the costs of taxation and receives the benefits of public spending after taking into account the way in which all policies, and their interactions with each other, affect individuals.
- Furthermore, were a particular generation to lose from the introduction and financing of a new policy, this could still enhance intergenerational fairness if that generation would otherwise have been in a privileged position due to the effect of other policies.<sup>7</sup>
- Borrowing only to invest over a cycle does not directly link the time profile of debt repayments with the time profile of the benefits flowing from an investment project that the debt has financed.

A related issue is the servicing of debts that have arisen from past breaches of the rule (i.e. to finance some of past generations' current spending). Under the current interpretation of the golden rule, payments required to service existing debt must (on average over the economic cycle) be covered by current tax receipts. However, since debt is structured in such a way that these interest payments tend to decline as a share of national income over time, it may be fairer to pass on some of this burden to the next generation (in the expectation that it and future generations will in turn continue to do so

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<sup>5</sup> P. Toigo and R. Woods, 'Public investment in the UK', paper presented at the 7<sup>th</sup> Banca d'Italia Public Finance Workshop, 2005.

<sup>6</sup> 'Brown faces "fiddle" claim after U-turn on the roads', *The Times*, 19 February 2005 (<http://www.timesonline.co.uk/article/0,,19809-1490602,00.html>).

<sup>7</sup> W. Buiter, 'Notes on "a code for fiscal stability"', *Oxford Economic Papers*, 2001, 53(1): 1–19.

ad infinitum) rather than to be the ‘transition’ generation that selflessly pays for its own and all outstanding past current spending.

- Fairness considerations might lead us to argue that future generations should pay for some of today’s current spending, as productivity growth arising from technological progress should make future generations financially better off on average and therefore give them greater ability to pay. In other words, running a current budget deficit would achieve progressive redistribution across the generations in the same way that the tax and benefit system achieves progressive redistribution within the current generation.

However, the current generation might be benefiting from one-off opportunities – for example, the exploitation of non-renewable natural resources such as North Sea oil reserves – which will therefore not be available to future generations. For exactly this reason Norway has made the decision to run budget surpluses in order to smooth out the consumption financed by these resources.

Even if a balanced current budget could be relied upon to deliver intergenerational fairness, that is not what Labour’s variant of the rule requires. Instead, it says the current budget should be in balance or in surplus. But the concept of intergenerational fairness underpinning the golden rule suggests that we should be as concerned if today’s taxpayers pay too much for current spending as if they pay too little.

For all these reasons, the golden rule is not an optimal mechanism to achieve intergenerational fairness. But it may well still have value as a rough-and-ready rule of thumb that is reasonable to use as a guide in most, but not necessarily all, time periods. In practice, it may not be worth sacrificing the transparency of the rule to get closer to optimality.

## **Taking account of the economic cycle**

Now to our second question regarding Labour’s interpretation of the golden rule: does it make sense to aim to achieve it over a specific economic cycle with defined start and end dates?

There is certainly a powerful case for taking some account of the condition of the economy in assessing the appropriate level of the current budget balance (or any other measure of borrowing or debt) at any given time. Government revenues and spending are both influenced directly by fluctuations in income, spending, transactions and employment. Economic activity can be thought of as fluctuating around a rising sustainable level consistent with stable inflation. When the economy is weak and activity is below the sustainable level (i.e. there is a negative output gap), tax revenues will be depressed temporarily and the government is likely to have to spend more on transfer payments for those not in paid work. This will tend to push the current budget towards deficit. Conversely, when the economy is above trend output, the budget will tend towards surplus.

Changes in national income affect current spending and taxes collected, with higher national income leading to lower spending and higher receipts. According to Treasury estimates, if national income were to rise by 1% relative to its sustainable level, current spending would be expected to fall by about 0.5% of national income while current receipts would be expected to

rise by about 0.2% of national income over the following two years. The net effect is to increase the current budget surplus by about 0.7% of national income.<sup>8</sup>

The Bank of England is tasked with using interest rates to pursue an inflation target, which implies that once inflation is on target, it will try to keep activity as close as possible to its sustainable level, which in turn should minimise any cyclical budget surplus or deficit. This implies that fiscal policy decisions should focus on the structural budget position (in other words, the position abstracting from the effect of the cycle). Broadly speaking, it might not be unreasonable to expect cyclical deficits and surpluses to sum to zero over the course of a single symmetric economic cycle. So, if tax and spending decisions also succeed in keeping the structural position in balance on average, the golden rule would be expected to be met.

Allowing borrowing to rise and fall through the economic cycle acts as an ‘automatic stabiliser’. If the government tried to keep the current budget balanced in every year of the cycle, it would need continuously to offset cyclical surpluses and deficits with structural deficits and surpluses respectively. This would typically mean implementing tax-raising measures and/or scaling back planned spending when a negative output gap leads to a cyclical deficit. Conversely, it would mean implementing tax-cutting measures and/or topping up planned spending when a positive output gap leads to a cyclical surplus. This would place a greater burden on monetary policy to stabilise the economy. It would also require temporary changes in tax rates that might well be more costly in economic terms than holding tax rates steady and allowing the current budget balance to fluctuate instead. It should be borne in mind that the strength of the automatic stabilisers will depend on the size of the public sector and the progressiveness of the tax, tax credit and benefit system, so it may not be optimal from a stabilisation perspective. However, there would be nothing to stop the Treasury from making additional discretionary policy changes in either direction, as long as they balanced out on average over the economic cycle, or from making changes to the tax, tax credit and benefit system in order to change the magnitude of the automatic stabilisers.

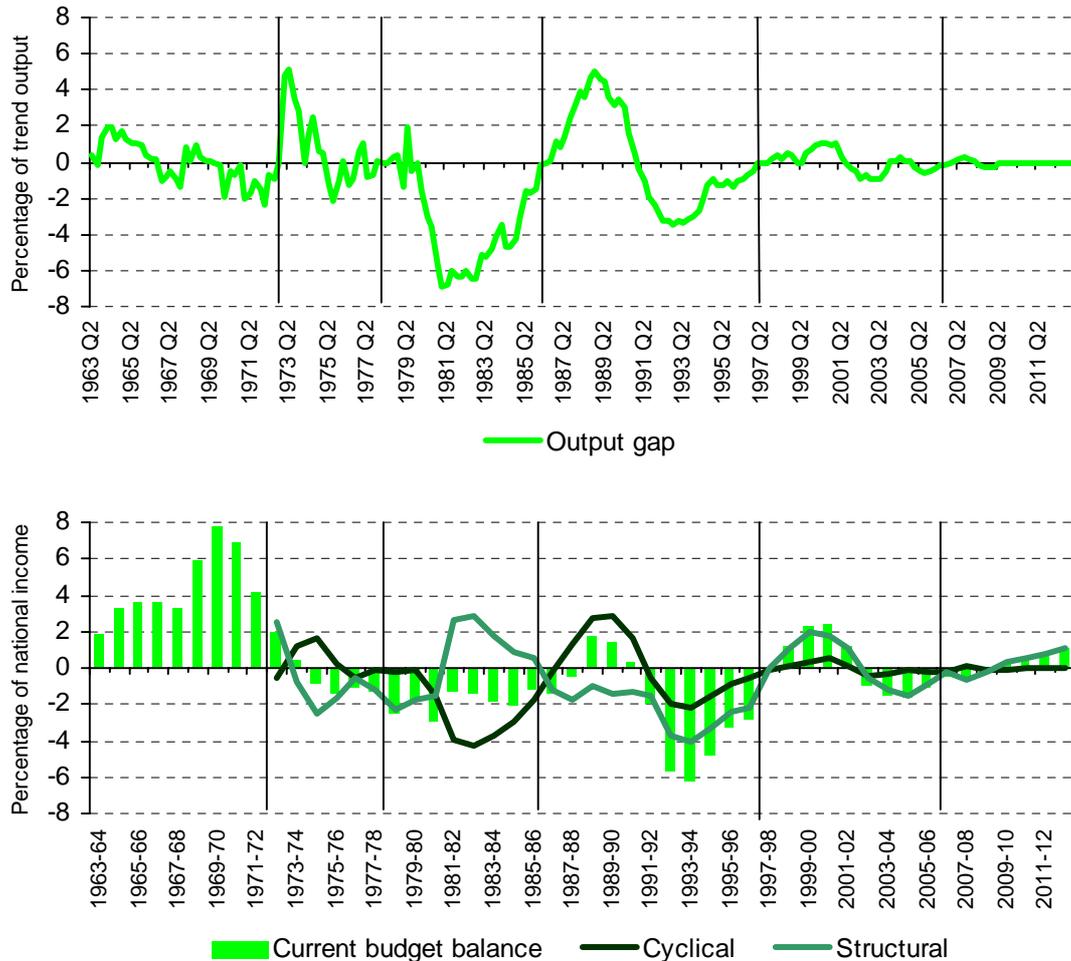
But it is one thing to argue that the government should aim to balance the structural current budget over some appropriate time horizon; it is another to argue that it should explicitly date a particular cycle and aim for a balance or surplus on average over that period. The Treasury identifies cycles by estimating, from a variety of economic indicators, points in time when economic activity was at its sustainable level and the output gap was zero (i.e. when there was neither upward nor downward pressure on inflation). It then assumes that the sustainable level of activity grows at a constant rate between these ‘on-trend’ points, allowing it to estimate the output gap at any other point. To date, it has chosen to define a cycle as a period of above-trend activity followed by a period of below-trend activity, although it could equally have opted for a below-trend one followed by an above-trend one.

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<sup>8</sup> As taxes and spending both equal roughly 40% of the economy, if national income were to rise by 1%, both revenues and spending would fall by about 0.4% of national income when compared with the size of the economy (assuming there were no change in their cash value). Treasury estimates suggest that, in addition to this ‘denominator’ effect, over the following two years we would see spending on transfer payments and debt interest payments drop by 0.1% of national income and revenues rise by 0.6% of national income. Adding the two effects together, after a 1% rise in national income relative to its sustainable level, we would see current spending fall by about 0.5% of national income while current receipts rise by about 0.2% of national income over the following two years. The net effect is to increase the current budget surplus by about 0.7% of national income. (HM Treasury, *End of Year Fiscal Report*, December 2003 ([http://www.hm-treasury.gov.uk/media/9/B/end\\_of\\_year\\_352f11.pdf](http://www.hm-treasury.gov.uk/media/9/B/end_of_year_352f11.pdf)).

Figure 3.1 shows the Treasury's estimates of the output gap<sup>9</sup> and the periods that it defines as economic cycles. It then shows the current budget balance, divided into its estimated 'structural component' (the level that it is estimated would have occurred had the output gap been zero throughout) and the estimated remaining 'cyclical' element which reflects the estimated impact of deviations in economic activity from its trend. These are based on the Treasury's estimates of the average output gap in each financial year.

Figure 3.1. Current budget balance: cyclical and structural



Note: HM Treasury's output gap estimate is measured using 'non-oil gross value added'.

Source: HM Treasury, *Public Sector Finances Databank*, October 2007 (<http://www.hm-treasury.gov.uk/media/8/A/publicfinancesdatabank251007.xls>).

One disadvantage of picking any fixed period over which to judge the rule is that the amount the government can borrow towards the end of the period is determined by what it has borrowed earlier on. Policy becomes backward-looking as the Chancellor is potentially constrained to compensate for the policy and forecasting errors of the past rather than setting what is necessarily the most sensible policy looking forward.

This is significantly different from the approach taken with monetary policy, where the Bank of England sets interest rates to try to achieve the inflation target at roughly a two-year time

<sup>9</sup> The output gap shown in Figure 3.1 is measured using 'non-oil gross value added' as the measure of output, in line with Treasury practice.

horizon without offsetting actual deviations from the target in the past or expected deviations from the target in the very near term (i.e. the Bank of England's Monetary Policy Committee (MPC) targets inflation rather than a particular price level – higher-than-target inflation in period 1 would not lead to the MPC trying to achieve lower-than-target inflation in period 2). An analogous approach for fiscal policy would be to set a rolling forward-looking target for the cyclically adjusted current budget balance (or just the total current budget balance if the policy horizon were sufficient to expect the output gap to have returned to zero). We argue below that the present government's approach can actually be interpreted in this way, given its published forecasts.

All this assumes that we can identify 'on-trend' points and the output gap at any given time. However, according to Barry Eichengreen of the University of California (Berkeley), 'The one thing economists know about cyclical adjustments is that we do not know how to do them'.<sup>10</sup>

The Treasury's method of identifying the start and end points of the cycle is largely a matter of judgement and there do exist other methods of identifying the cycle – including statistical filters and production function techniques – that can yield very different answers (as shown in Table 4.4 of Chapter 4). Typically, the Treasury technique identifies fewer cycles than the filters do.

Given the lack of consensus over the dating of the cycle from different methods, if the Treasury re-dates the cycle in a way that increases the average current budget surplus for the period over which the golden rule is being judged (as it did in 2005, discussed below), it will not be surprising if people suspect that this has been done to make the golden rule easier to meet.

An obvious alternative would be for the Treasury to present forecasts based on output gap estimates produced by an independent body or bodies, such as the Office for National Statistics (which is to be independent of government from 1 April 2008), perhaps advised by an external panel.

More fundamentally, does it make sense to base policy on a clearly defined economic cycle at all? In a stable environment in which monetary policy is well run and credible, we might expect deviations in economic activity from its sustainable level to be relatively small. Economic activity might show high-frequency noise around its trend rather than protracted periods with significantly positive or negative output gaps. This would make cycles increasingly hard to identify and more prone to re-dating as the National Accounts are revised.

As Mervyn King, Governor of the Bank of England, has argued,<sup>11</sup>

I am not even sure if the output gap is terribly well defined. To put precise numbers on it is pushing beyond the bounds of the plausible. The Bank and the Treasury have a very different view of how to think about the cycle. We don't like this sort of fixed

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<sup>10</sup> B. Eichengreen, 'Comment on "The political economy of fiscal adjustments"', *Brookings Papers on Economic Activity*, 1998, 1: 255–62.

<sup>11</sup> M. King, *Inflation Report* press conference, August 2005 (<http://www.bankofengland.co.uk/publications/inflationreport/2005.htm>).

dating and we have a different way of thinking about the productive potential of the economy and how it evolves. I am not even sure it makes sense to think about a cycle as if it is a well-defined phenomenon.

An alternative might be for the Treasury to set a target for the current budget in the medium term and constrain itself to present forecasts of revenues and spending based on some average of independent forecasts for growth and other macroeconomic variables. Or it could use the economic forecasts used by the Bank of England, which would presumably be advantageous since the same projections would be used for both fiscal and monetary policy. One pitfall of this approach is that it could increase the political sensitivity of the Bank of England's projections, which, over time, might risk reducing public confidence in their neutrality.

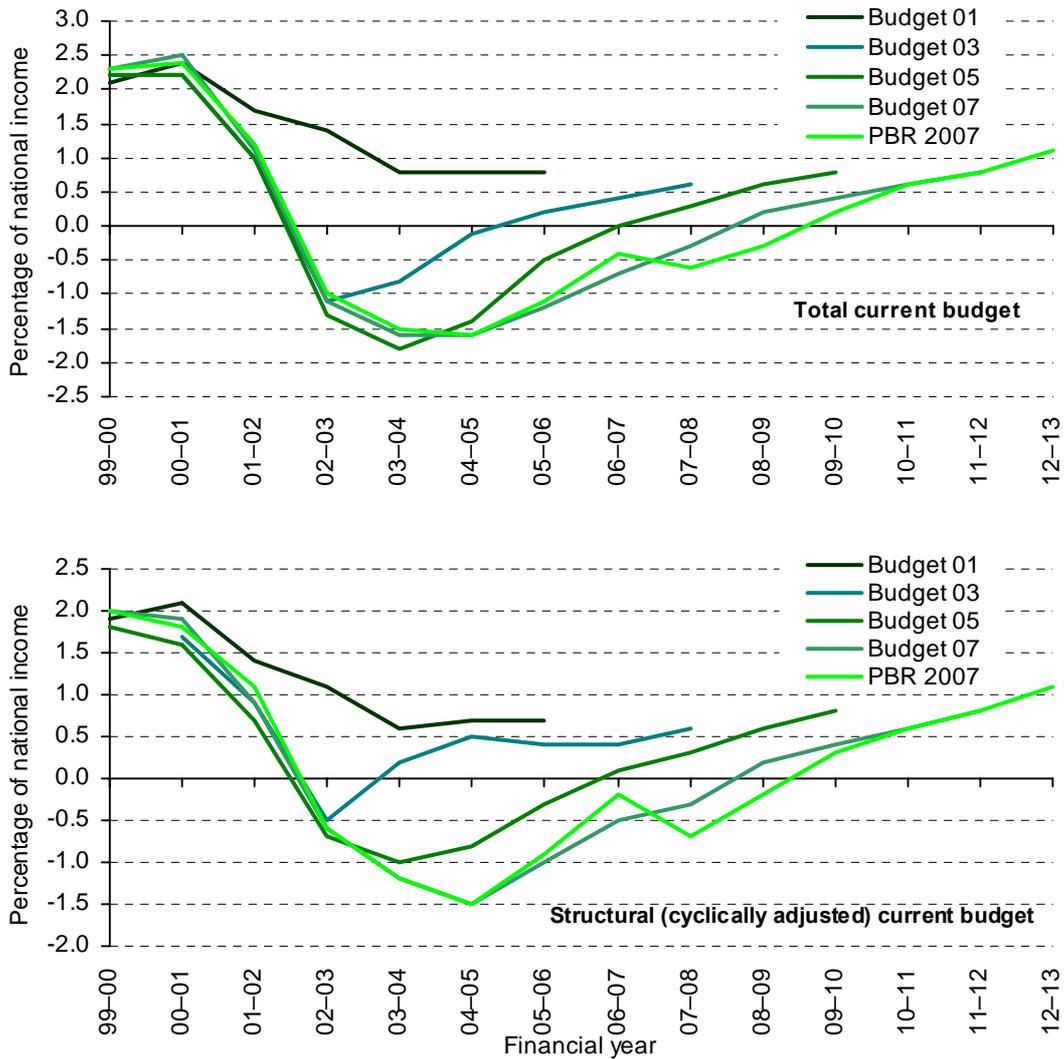
An even more dramatic option would be for more of the fiscal forecasting process to be delegated to an independent body, following the precedent of the Bank of England's MPC. For example, an independent body could be asked to provide official tax revenue forecasts, helped by access to information from HM Revenue & Customs. However, the Treasury has traditionally argued that it is impossible to separate responsibility for public finance forecasts or the economic inputs into them from the responsibility for making policy. We discuss this further in Section 3.4.

### **The golden rule in practice**

In understanding how Mr Brown chose to interpret and apply the golden rule in practice over recent years, it is important to remember that almost all the Treasury's forecasts for the public finances since 2001 have been over-optimistic and have hence been revised down in successive Budgets and Pre-Budget Reports (the one recent exception being the Budget 2006 projection for the strength of the public finances in 2006–07). In particular, following the stock market decline between 2000 and 2002, tax revenues from the financial sector were much weaker than had been expected by the Treasury. The latest downgrading of fiscal projections, in the 2007 Pre-Budget Report, again reflects downward revisions to expected revenues from the financial sector, although this time these arise from large price changes in the credit markets (see Section 6.3 and in particular Figure 6.6) rather than particularly poor stock market performance.

Figure 3.2 shows the Treasury's forecasts for the current budget balance from every other Budget since 2001 and the latest Pre-Budget Report. It shows that in 2001, the Treasury expected current budget surpluses over the medium-term forecasting horizon, clearly implying that the golden rule would be met over any economic cycle of plausible duration. However, in 2002–03, the current budget moved sharply into deficit. The Treasury's expectations of a swift return to the black were repeatedly frustrated and a current budget surplus is not now expected by the Treasury until 2009–10 – by which time it expects to have recorded seven successive years of deficits. As the second graph in Figure 3.2 shows, the unexpectedly weak fiscal performance was not thought to be explained in any large part by the impact of temporary weakness in the economy – Treasury forecasts for the structural current budget balance were revised downwards in similar fashion. The structural balance is also expected by the Treasury not to return to surplus until 2009–10.

Figure 3.2. Treasury current budget balance forecasts



Sources: Successive Budgets and 2007 Pre-Budget Report.

As Mr Brown’s hopes of continued surpluses were dashed and deficits began to mount up, exactly how the cumulative budget balance was calculated and the precise dating of the economic cycle became increasingly important in determining whether or not the golden rule was on course to be met – and, if so, with what degree of comfort. Over the early years of Labour’s rule, with large current budget surpluses, Gordon Brown quoted figures in his Budget speeches for the cumulative surplus as the sum of the cash surpluses over the cycle up to that point. As these surpluses began to dwindle, the method of presenting the cumulative surplus was changed to use instead the sum of the surplus as a share of national income in each year of the cycle so far. From the Treasury’s point of view, this had the advantage over the previous method of giving relatively more weight to the surpluses accrued in the early years of the cycle. Though the Treasury indicated in a 1999 document<sup>12</sup> that this latter method for calculating the cumulative surplus had always been the official method (and that the less

<sup>12</sup> Source: HM Treasury, *Analysing UK Fiscal Policy*, November 1999 (<http://www.hm-treasury.gov.uk/media/2/6/90.pdf>).

flattering sum of cash balances was only a ‘shorthand’ for use in speeches), simply changing the way in which the figures were presented created suspicion that Mr Brown had ‘moved the goalposts’.

This presentational issue was defensible given that the Treasury had set out early on (in Budget 1998) how the cumulative balance was to be officially calculated. However, greater suspicion was raised when Mr Brown began re-dating the economic cycle at a time when it began to look like he was in danger of breaching the golden rule (even using the less stringent method of calculating the cumulative surplus).

In Budget 2000, the Treasury had reached the ‘provisional conclusion’ that the present economic cycle began in financial year 1999–2000, a view it maintained up to and including the pre-election Budget in 2005. In that Budget, the Treasury argued the economy was running about 0.7% below full capacity and that above-trend economic activity would close the output gap ‘around the end of 2005’. For the purposes of the golden rule, this meant that there was one financial year still to come (2005–06) in a cycle spanning a total of seven years, as shown in Figure 3.3. The Treasury estimated in Budget 2005 that it would meet the golden rule over this period with around £5 billion to spare,<sup>13</sup> far lower than the margins implied over the same period by previous forecasts. But as 2005–06 got under way, it soon became clear that the current budget deficit was not shrinking as rapidly as planned. In June 2005, the Treasury published figures showing that the deficit in the first two months of the financial year was only about 10% smaller than in the same period of 2004–05.<sup>14</sup> If this had persisted, it would have come in at around £15 billion rather than the £5.7 billion forecast in Budget 2005: these figures therefore implied that the golden rule was on course to be breached.

Then, a month later, the Treasury published a detailed analysis arguing that the period from mid-1997 to mid-1999 should be regarded as part of the up-phase of the current cycle rather than as a complete mini-cycle in its own right. This added two additional financial years to the beginning of the cycle and extended it from seven to nine years. The Treasury justified this change largely on the grounds that revisions to National Accounts data showed that economic growth in 1999 had been stronger than hitherto thought.<sup>15</sup> At a stroke, adding the two extra years to the beginning of the cycle put the Treasury back on course to meet the golden rule, thanks to the current budget surplus of 1.2% of national income recorded in 1998–99 (which outweighed the 0.1% of national income deficit in the previous year). The fortuitous timing of the Treasury’s decision to re-date the cycle inevitably fuelled speculation that it had been motivated by the desire to make the golden rule easier to meet.

We have argued in the past that if one were to accept the Treasury’s methodology and estimates for the output gap, it would be quite plausible to suggest that the cycle began in

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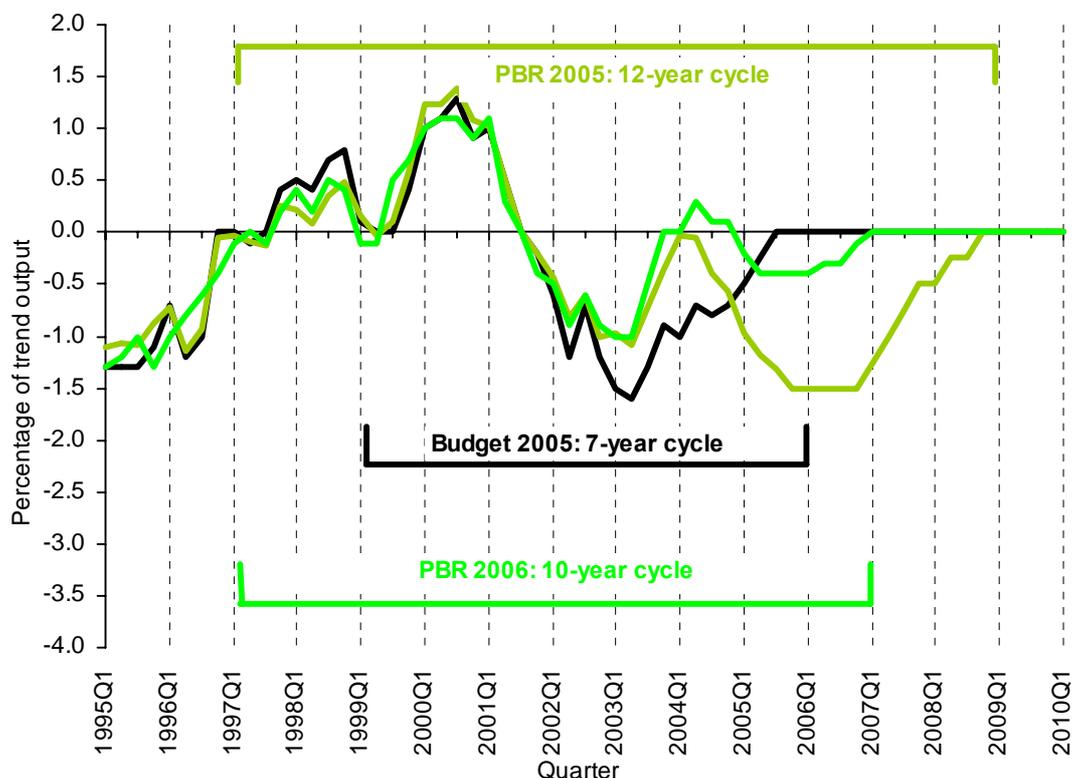
<sup>13</sup> Cash value of cumulative current budget surpluses across the cycle, with surpluses in each year measured as shares of national income and then converted to cash terms using 2005–06 money GDP.

<sup>14</sup> Office for National Statistics and HM Treasury, *First Release: Public Finances, May 2005*, June 2005 (<http://www.statistics.gov.uk/pdfdir/psf0605.pdf>).

<sup>15</sup> HM Treasury, *Evidence on the UK Economic Cycle*, July 2005 ([http://www.hm-treasury.gov.uk/media/7/7/economic\\_cycles190705.pdf](http://www.hm-treasury.gov.uk/media/7/7/economic_cycles190705.pdf)).

1997 rather than 1999.<sup>16</sup> But the case for making this judgement in the summer of 2005 seemed little stronger than at any time in the previous five years.<sup>17</sup> So it is hardly surprising that extending the cycle at precisely the point at which, without this change, the government looked on course to break rather than meet the rule should undermine the credibility of the policy framework and create suspicion that Mr Brown simply ‘moved the goalposts’ to avoid the embarrassment of missing his target.

Figure 3.3. The output gap and the economic cycle: Treasury estimates



Note: Actual output less trend output as a percentage of trend output (non-oil basis).  
Source: HM Treasury.

After this first revision, revisions two and three followed relatively quickly:

- Six months later, in the Pre-Budget Report of 2005, Mr Brown announced that he expected the cycle to end in 2008–09 rather than 2005–06. Given the forecasts for the current budget balance over the three additional years, this marginally increased the comfort with which the Treasury expected to meet the rule, but with greater uncertainty around the central forecast because of the longer time horizon.
- A year after this, in the Pre-Budget Report of 2006, prompted by revisions to the National Accounts, Mr Brown said that the cycle would close in early 2007, implying that the final financial year of the cycle would be 2006–07 rather than 2008–09, cutting it to 10 years. This reduced the degree of comfort with which the golden rule was expected to be met

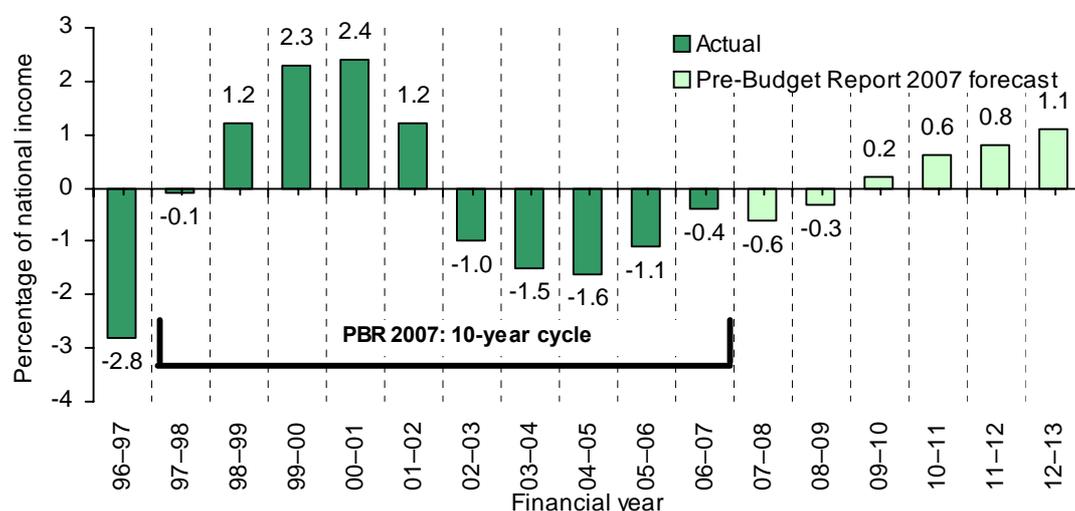
<sup>16</sup> C. Emmerson, ‘Bending the rules?’, *Public Finance Magazine*, 5 August 2005 ([http://www.cipfa.org.uk/publicfinance/features\\_details.cfm?News\\_id=24755](http://www.cipfa.org.uk/publicfinance/features_details.cfm?News_id=24755)).

<sup>17</sup> See pages 20–26, chapter 2 of R. Chote, C. Emmerson, R. Harrison and D. Miles (eds), *The IFS Green Budget: January 2006*, IFS Commentary 100 (<http://www.ifs.org.uk/budgets/gb2006/index.php>).

under the Treasury’s forecasts. However, by reducing the time remaining until the end of the cycle, it also reduced the uncertainty around this central forecast.

Figure 3.4 shows recent out-turns and Treasury forecasts for the current budget balance from the 2007 Pre-Budget Report. Over the 10 financial years from 1997–98 to 2006–07, the current budget is estimated to have been in surplus by an average of 0.1% of national income, which is just £2 billion per year in 2007–08 terms. Therefore, as long as there are no significant net data revisions over this period and the Treasury is correct in its view that an economic cycle spanned these 10 years, the golden rule will have been met, albeit by a small margin, over this period. Ironically, it is also the case that the golden rule would have been met, or at least would still be on course to have been met, under either of the previous two datings of the economic cycle published by the Treasury (1999–2000 to 2005–06 and 1997–98 to 2008–09).

Figure 3.4. Current budget balance in the 2007 Pre-Budget Report



Sources: HM Treasury, *Public Sector Finances Databank*, October 2007 (<http://www.hm-treasury.gov.uk/media/8/A/publicfinancesdatabank251007.xls>); HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 ([http://www.hm-treasury.gov.uk/pbr\\_csr/pbr\\_csr07\\_index.cfm](http://www.hm-treasury.gov.uk/pbr_csr/pbr_csr07_index.cfm)).

It is also not yet known whether or not the golden rule will be met over the new economic cycle that the Treasury estimates suggest we are now in. One problem in judging this is that although the Treasury has reached a provisional judgement that the current economic cycle ended in 2006–07, it has not decided, in that event, which year would be the first of the next cycle. Paul Boateng, the then Chief Secretary to the Treasury, said in 2003 that ‘Progress against the golden rule is measured by the average surplus on the current budget over the period from the financial year in which the economic cycle starts up to and including the financial year in which it ends’.<sup>18</sup> This would seem to imply that if 2006–07 is treated as the last year of one economic cycle, it should also be treated as the first year of the next. But, in response to questioning by the Treasury Select Committee in December 2006, Treasury officials left open the option of dropping this approach:

<sup>18</sup> *Hansard*, 4 November 2003, column 630w ([http://www.parliament.the-stationery-office.co.uk/pa/cm200203/cmhansrd/vo031104/text/31104w26.htm#31104w26.html\\_spnew3](http://www.parliament.the-stationery-office.co.uk/pa/cm200203/cmhansrd/vo031104/text/31104w26.htm#31104w26.html_spnew3)).

**David Gauke MP:** But whenever it does end, whichever year it is, will that year count for both the old cycle and the new cycle?

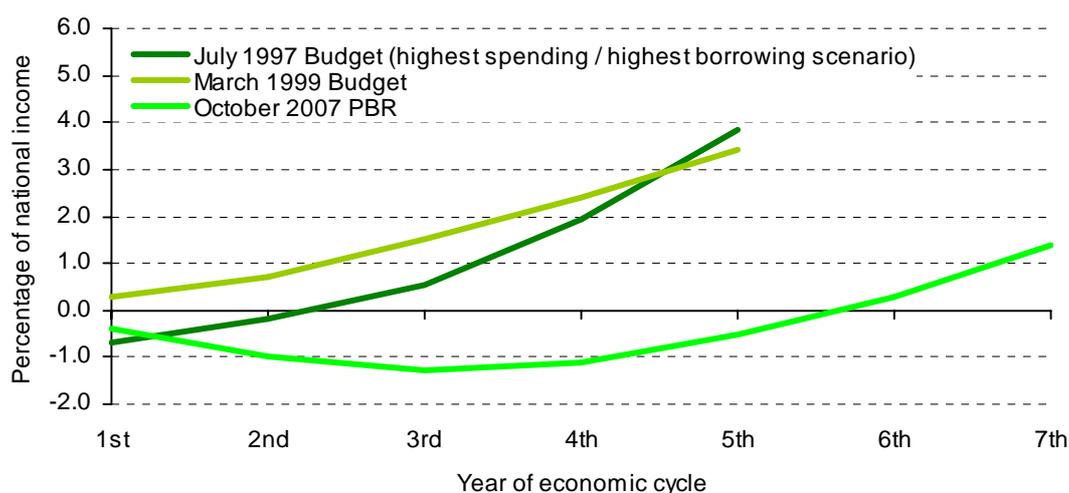
**Jon Cunliffe (HM Treasury):** That is what we have done in the past.

**David Gauke MP:** Is that what you are going to do in the future?

**Jon Cunliffe (HM Treasury):** I do not know what we are going to do in the future.<sup>19</sup>

If the Treasury were to count 2006–07 as the first year of the next cycle, it would begin with a current budget deficit of 0.4% of national income that would need to be offset by a surplus of at least the same size later in the cycle (Figure 3.4). If the Treasury’s projections for the current budget are correct then it would be missed if this cycle closed in 2010–11 or earlier, and would be met if it closed in 2011–12 or later (as shown in Figure 3.5). This is a decidedly less comfortable position than Gordon Brown’s in 1997, when the last economic cycle is now thought to have started, or in 1999, which at the time was thought to be the start of a new economic cycle. In addition to the latest Treasury forecasts from PBR 2007, Figure 3.5 shows the cumulative current budget surpluses that were forecast in the July 1997 Budget (under the Treasury’s most pessimistic scenario for the public finances) and the March 1999 Budget. The horizontal axis shows the year of the cycle (either based on what is currently believed, or what was believed at the time): for the Budget 1997 forecast, year 1 is 1997–98; for the Budget 1999 forecast, year 1 is 1999–2000; and for the PBR 2007 forecast, year 1 is 2006–07. The graph shows that the July 1997 Budget forecast that the cumulative current budget would return to balance by the end 1999–2000 (the third year of the cycle that the Treasury now thinks began in 1997–98). The forecasts in the Budget of March 1999, at which time the Treasury thought the economy was just beginning a new cycle, were even stronger – these forecasts were for a cumulative current budget surplus in each of the following five years. In contrast, the latest Treasury projections suggest that a cumulative current budget surplus since 2006–07 will only be achieved by year 6, i.e. in 2011–12. In this sense, the outlook for the

Figure 3.5. Treasury cumulative current budget balance forecasts



<sup>19</sup> <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/uc115-ii/uc11501.htm>.

Table 3.1. Economic cycles and compliance with the golden rule since 1997

Possible dating economic cycles	Average surplus		Golden rule met?
	% of GDP	£bn	
<b>Using Treasury's estimates of the output gap</b>			
<i>Any movement from below to above trend (4 cycles)</i>			
Cycle 1: 1997–98 to 1999–2000 (3 years)	+1.1	+15	Met
Cycle 2: 1999–2000 to 2003–04 (5 years)	+0.7	+9	Met
Cycle 3: 2003–04 to 2006–07 (4 years)	-1.1	-16	Missed
Cycle 4: 2006–07 to ???–?? (length unknown)	n/a	n/a	n/a
<i>3 cycles:</i>			
Cycle 1: 1997–98 to 2003–04 (7 years)	+0.6	+9	Met
Cycle 2: 2003–04 to 2006–07 (4 years)	-1.1	-16	Missed
Cycle 3: 2006–07 to ???–?? (length unknown)	n/a	n/a	n/a
<i>2 cycles (current Treasury view)</i>			
Cycle 1: 1997–98 to 2006–07 (10 years)	+0.1	+2	Met
Cycle 2: 2006–07 to ???–?? (length unknown)	n/a	n/a	n/a
<i>1 cycle:</i>			
Cycle 1: 1997–98 to ???–?? (length unknown)	n/a	n/a	n/a
<b>Using HP 1,600 statistical filter estimates of the output gap</b>			
<i>3 cycles:</i>			
Cycle 1: 1994–95 to 2003–04 (10 years)	-1.2	-16	Met
Cycle 2: 2003–04 to 2006–07 (4 years)	-1.1	-16	Missed
Cycle 3: 2006–07 to ???–?? (length unknown)	n/a	n/a	n/a

Note: The financial year during which an economic cycle is judged to have ended is assumed to be the first year of the next cycle. See Section 4.3 for other estimates of the output gap and dating of the cycle using statistical filters.

Sources: HM Treasury, *Public Sector Finances Databank*, December 2007 ([http://www.hm-treasury.gov.uk/media/B/2/pfd\\_211207.xls](http://www.hm-treasury.gov.uk/media/B/2/pfd_211207.xls)); authors' calculations.

public finances is much weaker at the beginning of this economic cycle than it appeared to be at the beginning of the last.

However, whether or not the golden rule has in fact been met since 1997 and whether it will be met going forwards remains at least to some degree a matter of judgement. Even if an economic cycle is defined as a period of above-trend activity followed by a period of below-trend activity, and the Treasury's latest estimates of the output gap are correct, it is far from clear that there has been one economic cycle running from 1997–98 to 2006–07 (inclusive).

As shown in Table 3.1, judgements different from those made by the Treasury as to what constitutes a decisive movement from below to above trend can lead to different assessments of whether or not the golden rule has been met since 1997. If instead of there having been one long cycle from 1997–98 to 2006–07, there were in fact three shorter cycles, over the last of these (the one running from 2003–04 to 2006–07) the golden rule would have been judged to have been missed by a sizeable margin. In contrast, under the last scenario presented in the top panel of Table 3.1 – namely, that the current economic cycle began in 1997–98 and is yet

to end – the golden rule is set to be met if the cycle ends at any point during the medium-term forecast horizon.

If estimates of the output gap from a commonly used statistical filter (Hodrick–Prescott 1,600 filter; see Section 4.3 for more details) were used instead of the Treasury’s estimates of the output gap, then the dating of the economic cycle is far less ambiguous, but unfortunately also different from any of the datings from analysis of the Treasury’s data. As shown in the bottom panel of Table 3.1, this filter implies that an economic cycle covered the 10 financial years from 1994–95 to 2003–04, over which the golden rule would have been missed by an average of 1.2% of national income a year, or £16 billion in today’s terms. The subsequent economic cycle is estimated to cover the four financial years from 2003–04 to 2006–07, over which the golden rule would have been missed by a similar margin.

So it is clear that both typical revisions to estimates of the output gap and different judgements of what constitutes a decisive movement from below- to above-trend activity can lead to different datings of the economic cycle. These in turn lead to very different judgements of whether or not the golden rule has been met, which suggests that this is a far from satisfactory way of assessing the appropriateness, or otherwise, of fiscal policy.

One option would be for the Treasury to commit to using estimates of the output gap that were produced solely using publicly available National Accounts data and a statistical filter, such as the Hodrick–Prescott 1,600 filter used in Table 3.1. This would have the advantage of removing any suspicion that revisions to estimates of the output gap had been made as a result of political considerations. However, these filters are not without problems, and this approach would come at the cost of not allowing a valid judgement to be made that the output gap estimates should deviate from the estimates produced using the filter. In addition, filters provide no rules for judging when an economic cycle starts and finishes, and so what constituted an economic cycle would still be left as a matter of judgement.

We noted earlier in this section that one alternative to meeting the golden rule over a specifically dated economic cycle would be to aim for a particular target level for the current budget balance over an appropriate time horizon. As Figure 3.2 illustrates, it could be argued that in practice the government has in fact been pursuing just such a target in recent years: it has made tax and spending decisions that it forecasts in each Budget will deliver a current budget surplus (total or cyclically adjusted) of around  $\frac{3}{4}$ % of national income after five years.

How has the Treasury performed relative to these notional targets?

Table 3.2 shows that the five-year-ahead target set in Budget 2001 was undershot by 1.9% of national income in 2005–06, of which 0.2% reflects the fact that the economy was running below potential. Budget 2002 loosened the target for 2006–07 by 0.1% of national income, but it was still undershot by 1.0% of national income, of which 0.1% reflects a weak economy. Budget 2003 loosened the target again by 0.1% of national income, and the Treasury now expects to undershoot this by 1.2% of national income. In the next two Budgets, the target was increased slightly, and the Treasury is now expecting to miss these targets by 1.0% of national income in 2008–09 and 0.6% of national income in 2009–10. Budget 2006 set a five-year-ahead target of 0.8% of national income for 2010–11, and the Treasury already expects to be 0.2% of national income adrift from that. However, the target

of a 0.8% of national income surplus on the current budget in 2011–12 set in Budget 2007 is still expected to be met by the Treasury.

It would be reasonable to argue that more caution is needed over a longer time frame since there is greater uncertainty. Therefore the ¾% of national income might never need to be achieved – particularly if the Chancellor only wanted to achieve a structural current budget balance. However, as shown in the bottom panel of Table 3.2, recent years have seen sizeable structural current budget deficits.

Table 3.2. Performance against notional five-year rolling target

<b>Current budget balance (% of national income)</b>	<b>2005–06</b>	<b>2006–07</b>	<b>2007–08</b>	<b>2008–09</b>	<b>2009–10</b>	<b>2010–11</b>	<b>2011–12</b>
<b>Target set 5 years previously (total &amp; structural)</b>	0.8%	0.7%	0.6%	0.7%	0.8%	0.8%	0.8%
<b>Total</b>							
<i>Actual deviation</i>	-1.9%	-1.0%	–	–	–	–	–
<i>Forecast deviation</i>	–	–	-1.2%	-1.0%	-0.6%	-0.2%	0.0%
<b>Structural</b>							
<i>Actual deviation</i>	-1.7%	-0.9%	–	–	–	–	–
<i>Forecast deviation</i>	–	–	-1.3%	-0.9%	-0.5%	-0.2%	0.0%

Source: Projections from various HM Treasury Budgets. Latest out-turns from HM Treasury, *Public Sector Finances Databank*, November 2007 ([http://www.hm-treasury.gov.uk/media/C/B/pfd\\_301107.pdf.xls](http://www.hm-treasury.gov.uk/media/C/B/pfd_301107.pdf.xls)).

The current budget underperformed the Treasury’s notional Budget 2001 target for 2005–06 and the Budget 2002 target for 2006–07 largely because of the unexpected fall in tax revenue from the financial sector in 2000–01 and 2001–02 failing to rebound as quickly as it hoped and because of decisions to spend more on health, education and tax credits. Over the period from 2002 to 2006 (inclusive), IFS Green Budgets have been less optimistic than the Treasury about tax revenues. To achieve the sort of improvement in the public finances that Mr Brown was looking for, we said there would be need for tax increases and/or spending cuts worth roughly 0.6% of national income in the 2002 Green Budget, and roughly 1% of national income in the Green Budgets of 2003, 2004 and 2005.

Mr Brown consistently rejected this advice in the run-up to the 2005 election, but then followed it at the first opportunity once polling day was safely out of the way – he announced tax increases and signalled cuts in spending plans worth in total around 1% of national income in the 2005 Pre-Budget Report. We argued for a further tightening of 0.2% of national income in Green Budget 2006, and tax increases worth roughly this amount were delivered in the 2006 Budget and Pre-Budget Report.

In the 2007 Green Budget, we saw no need for a further significant tightening of policy to deliver the Treasury’s desired improvement in the public finances over the subsequent five years and noted that ‘the Treasury’s revenue forecasts have been over-optimistic for six years now, and history suggests that at some point it will be due for a run of better luck’.<sup>20</sup> The

<sup>20</sup> Section 5.5 of R. Chote, C. Emmerson, A. Leicester and D. Miles (eds), *The IFS Green Budget: January 2007*, IFS Commentary 102, January 2007 (<http://www.ifs.org.uk/budgets/gb2007/index.php>).

Treasury was indeed able to report in the 2007 PBR that in 2006–07 the current budget balance had turned out better than predicted in the preceding Budget for the first time in six years – thanks both to higher-than-expected revenues and lower-than-expected spending. Victory has been short-lived, however, with the problems in credit markets and the financial sector that began last summer forcing the Treasury to downgrade its forecasts for 2007–08, 2008–09 and 2009–10 (as we have also had to do; see Chapter 5). But it expects the impact of these problems to be temporary and has left its forecasts for 2010–11 and 2011–12 as they were in the Budget.

As we discuss in Chapter 5, the key question surrounding the outlook for the current budget is whether the Treasury is correct to assume that the impact of recent financial sector problems will be modest and short-lived – or whether it is about to repeat the mistake of Labour’s second term, when it was repeatedly overoptimistic about the recovery of the public finances following the decline in the stock market. If it is, the prospects of meeting the golden rule over the economic cycle just getting under way may be less rosy than the government hopes.

In addition to seeking intergenerational fairness, the golden rule was motivated in part by a desire to ensure that public sector net investment does not suffer a disproportionately severe squeeze when spending overall has to be restrained. When spending was squeezed early in Labour’s term in office, this did not succeed: public sector net investment fell (albeit at least in part unintentionally) by 2.4% per year in real terms between 1996–97 and 1999–2000, while current spending (including depreciation) increased by 0.3% per year. But if the Treasury’s current plans are delivered, investment will be protected over the three years of the Comprehensive Spending Review: public sector net investment is expected to increase by 4.5% in real terms on average per year between 2007–08 and 2010–11, compared with an increase of 1.9% per year for current spending. If achieved, this would also be in stark contrast to the last four years of the previous Conservative government, which delivered increases in current spending averaging 1.6% per year between 1992–93 and 1996–97 (i.e. only slightly below Labour’s current plans) but cut investment spending by 19.5% per year.

### **3.3 The sustainable investment rule**

The sustainable investment rule states that the public sector’s debt (net of its short-term financial assets, which mostly comprise foreign exchange reserves) should be kept at a ‘stable and prudent’ level. More precisely, ‘To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle’.<sup>21</sup> However, while this 40% of national income ceiling applies over the economic cycle that the Treasury believes ran from 1997–98 to 2006–07, it is yet to announce whether or not this ceiling will remain in place over the new economic cycle.

Governments take on debt for much the same reason that individuals and firms do – to smooth their spending. Whilst the biggest changes in government debt levels in this country have been driven by the need to finance the two World Wars, in more normal circumstances there are three main reasons why governments might take on debt:

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<sup>21</sup> Page 20, paragraph 2.13 of HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 ([http://www.hm-treasury.gov.uk/pbr\\_csr/pbr\\_csr07\\_index.cfm](http://www.hm-treasury.gov.uk/pbr_csr/pbr_csr07_index.cfm)).

- First, it can be both fair and efficient to smooth the cost to taxpayers of public spending that yields a flow of (typically non-financial) benefits into the future.
- Second, it may make sense to smooth payments for current spending over the ups and downs of the economic cycle to help stabilise activity and alleviate pressure on monetary policy.
- Finally, and less commendably, governments may seek to push the costs of current spending onto future taxpayers for political advantage, because they believe that voters are short-sighted.

## Why impose a debt ceiling?

When does debt – taken on for any or all these reasons – become ‘unsustainable’? As the Treasury argues, ‘There are many possible definitions of sustainability. One definition is that a government should be able to meet its obligations if and when they arise in the future’.<sup>22</sup> As debt increases, the cost of servicing it also increases. In principle, the cost could rise so high that the economy produces too little to meet it. But in practice, long before then, sustainability becomes a political judgement: the ability of a government to meet the obligations it undertakes or inherits will depend on the willingness of future taxpayers to provide the revenue or to sacrifice other spending.

As experience in various emerging market countries has shown over the decades, *in extremis* governments may find it more attractive to lift the burden of meeting their financial obligations from taxpayers and concentrate it instead on their domestic and/or international creditors through rescheduling, default or inflation. Conscious of this danger, investors will become more reluctant to lend to a government if its policies look likely to impose a politically unacceptable burden on future taxpayers. By increasing interest rates and reducing economic growth, such investor fears can become self-fulfilling by further increasing the government’s obligations and simultaneously shrinking the resources available to meet them. Even in the absence of a significant default risk, interest rates may rise as government debts increase, weakening growth by ‘crowding out’ private investment. (This market discipline has been relatively weak in recent years, with most industrial countries seeing their borrowing costs fall even as their debts have risen, as discussed in Chapter 6.)

Given these dangers, it may be sensible for a government to make a clear public commitment to limit its obligations to some level that would not (under plausible economic circumstances) impose an unacceptable burden on future taxpayers. As Treasury officials have argued, ‘Committing to a clear benchmark level of debt helps to anchor expectations and helps avoid self-fulfilling losses of credibility in fiscal policy’.<sup>23</sup>

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<sup>22</sup> Page 19 of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 ([http://www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr06/assoc\\_docs/prebud\\_pbr06\\_adlongterm.cfm](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adlongterm.cfm)).

<sup>23</sup> R. Woods, ‘The role of public debt in the UK fiscal rules’, paper presented at the 6<sup>th</sup> Banca d’Italia Public Finance Workshop, 2004.

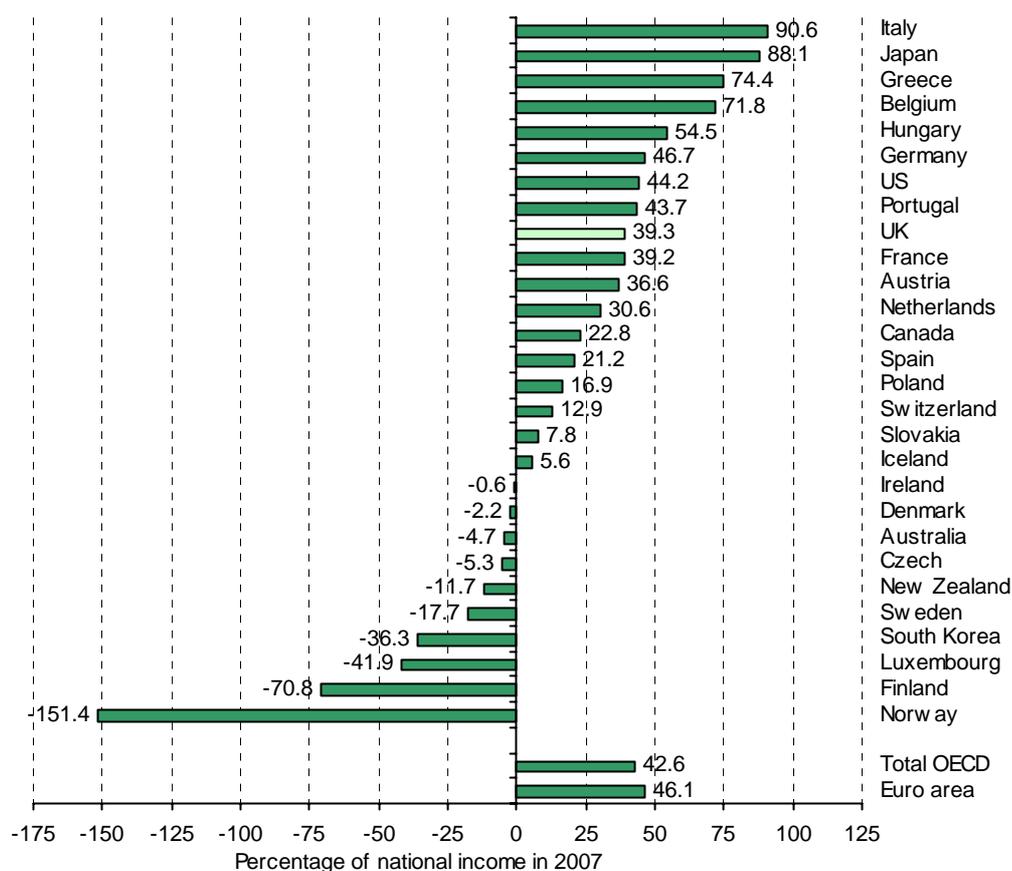
## The height of the debt ceiling

Choosing where to set the debt ceiling is no easy task. For one thing, taxpayers' willingness to meet the obligations implied by past policy decisions may depend on a whole host of factors: the existing tax burden they face, the size of the debt interest bill, the reason the debt was incurred, the identity of the creditors and so on. Attempts have been made to infer an optimal debt ratio from comparisons with the debt/equity ratios prevailing in the private sector and from theoretical and empirical analyses of the relationship between debt levels, interest rates and economic growth rates. None has given a precise or robust result.

It certainly seems implausible to suggest that a debt ratio of up to 40% of national income would be sufficient to trigger a sovereign debt crisis, especially for a developed country such as the UK that has long been able to borrow in its own currency with relative ease. The current government appears to have chosen this ratio in effect as a commitment not to allow debt to rise above the level it inherited. Assuming that the golden rule was met, a debt ceiling of 40% of national income would also be sufficiently high to permit a higher level of public sector net investment in the long term than Labour inherited.

The Treasury estimates that public sector net debt will be 37.6% of national income this year. Figure 3.6, which uses a slightly different definition of debt to aid international comparison,

Figure 3.6. General government debt ratios in OECD countries in 2007



Source: Annex table 33 of OECD, *Economic Outlook No. 82*, December 2007  
[http://www.oecd.org/document/61/0,3343,en\\_2649\\_201185\\_2483901\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/61/0,3343,en_2649_201185_2483901_1_1_1_1,00.html).

shows that even if public sector debt in the UK did rise by the 2.4% of national income necessary to reach the 40% of national income level, it would still be low relative to that of most other G7 countries. But there are other industrial countries with much stronger net debt positions, including Australia, New Zealand and the Scandinavian countries. Ten out of the 28 OECD countries shown in the graph have more financial assets than debt – for example, Norway (to smooth the expenditure financed by its oil revenues) and South Korea (which has built up enormous foreign exchange reserves to limit the rise in its exchange rate). Looking at the change in net debt over the period from 1996 to 2007, the majority of OECD countries have reduced their net debt by more than the UK did over this period (see Table 2.2). This suggests that many countries are trying to reduce their level of net debt, whereas in the UK Labour has only sought to prevent it from rising. Similarly neither the opposition Conservative nor Liberal Democrat party has proposed anything different.

So why might the UK wish to aim for a debt ratio higher or lower than 40%?

First, the desired debt ratio will depend on the desired level of public sector net investment over the long term. The amount the government can invest while adhering to a particular debt ceiling will depend on: (a) the current level of debt; (b) the degree to which the golden rule is over- or under-achieved (which in turn partly depends on how much the government has to spend servicing its existing debt); and (c) the growth of the cash value of the economy.

If we assume that the golden rule is met exactly, whole-economy inflation is 2.5% a year and the economy grows in real terms by 2.5% a year, then the government could sustain public sector net investment of 2% of national income a year while keeping public sector net debt at 40% of national income.<sup>24</sup> If we believe that public sector net investment should be higher than 2% of national income in the long term, this argues for raising the debt ceiling above 40% unless the golden rule is consistently overachieved or cash growth in the economy exceeds 5% a year. Conversely, if we wish to invest less than 2% of national income, the debt ceiling could be lowered.

Second, a Chancellor might move the debt ceiling due to a belief that the underlying level of current spending is likely to rise (or fall) from its present level at some point in the future in order to limit economically costly variation in tax rates. This could be done without altering the level of investment by deliberately over- (or under-) achieving the golden rule for a while and temporarily reducing (or increasing) the debt ceiling. For example, some Scandinavian economies are deliberately pursuing low or negative net debt positions now because they believe that the ageing of their populations will require more public spending on the elderly in future decades. By running tight fiscal policies today, and giving themselves greater scope to borrow more in the future, they can limit future increases in tax rates and the associated disincentives to work and save.

In November and December of each year from 2002 to 2006, the Treasury published a report on the long-term strength of the public finances. In its December 2006 report, the Treasury estimated that, on existing policies, public spending in the UK would, as a result of changing demographics, rise from 40.9% of national income last year to 44.7% in 2055–56 – an

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<sup>24</sup> Debt interest payments would also not rise as a share of national income as long as nominal interest rates were not above 5% p.a.

increase of 3.8% of national income or just over £50 billion in today's terms.<sup>25</sup> Unfortunately, the Treasury has not, as yet, published an update to its 2006 report.

Individuals are likely to wish to smooth their consumption in the face of an expected rise in tax rates to pay for these increases in spending, but some will be more aware of the necessary adjustments and better placed to make them at low cost than others. On these grounds, it may be thought preferable for the state to help make the adjustment by increasing tax rates now (aiming for a lower debt-to-national-income target) to reduce the increase required in the future (when the debt ratio would be allowed to rise again).

## **Other liabilities**

As well as future debt repayments due to current borrowing, the government has made promises of other future payments in a number of ways. These include future payments arising from the pensions of public sector workers – both those who are yet to receive their pension and those who are already receiving their pension – and also a number of liabilities that would be incurred should a certain event(s) occur (known as contingent liabilities). These contingent liabilities include future payments made under Private Finance Initiative (PFI) contracts, which would be incurred under the, presumably likely, scenario that the private sector providers fulfil the terms of their contract. There are also many other contingent liabilities, some of which will be unlikely to occur; in this section, we focus solely on the debt of Network Rail and the more recent Treasury-backed Bank of England support for Northern Rock PLC, since these have been the subject of much discussion in recent months and years. The treatment of all these future payments is potentially important since, despite not appearing in the headline figures for debt, each could reduce the amount of income that future generations will be able to spend as they choose.

The opposition Conservative Party,<sup>26</sup> among others, has expressed concern at the size of the liabilities that are not counted in public sector net debt, and therefore are not constrained (at least in the short and medium term) by the sustainable investment rule. Arguably more important than the level of these liabilities is whether or not the total indebtedness of the public sector is increasing and the appropriateness of the financing tool used. Financing this spending through means that do not immediately score against public sector net debt would be inappropriate if it is done in order to keep the headline net debt figure low rather than for reasons of economic efficiency. For example, Section 8.4 puts forward the argument that better value for money for the taxpayer might be achieved through a combination of less generous pensions for public sector workers compensated in part with higher pay.

How large are these commitments that are not included in public sector net debt (PSND)? Due to intrinsic differences in their nature, comparable figures (based on consistent

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<sup>25</sup> Source: Table 5.1, page 40 of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 ([http://www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr06/assoc\\_docs/prebud\\_pbr06\\_adlongterm.cfm](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adlongterm.cfm)).

<sup>26</sup> See, for example, Conservative Party, *Developing a Conservative Macroeconomic Framework*, December 2005 (<http://www.conservatives.com/pdf/Macroeconomicframework-Dec2005.pdf>). Also, Shadow Chief Secretary to the Treasury, Philip Hammond: 'This is the worst possible time to be adding yet more liabilities to the Government's balance sheet by entrenching UK taxpayers' exposure to Northern Rock', Conservative Press Release, 21 January 2008 ([http://www.conservatives.com/tile.do?def=news.press.release.page&obj\\_id=141775](http://www.conservatives.com/tile.do?def=news.press.release.page&obj_id=141775)).

underlying assumptions) for different components of public sector indebtedness are not available. Bearing in mind this important caveat, Table 3.3 compares the size of PSND with official estimates of public sector pension liabilities and an estimate of the value of the future flow of payments to PFI providers under contracts already signed (which is assuming that the private sector providers do fulfil the terms of these contracts). Also shown are two other relatively high-profile contingent liabilities – namely, the debt of Network Rail and the recent Treasury-backed Bank of England support for Northern Rock PLC.

Quantitatively speaking, compared with the official measure of PSND, PFI liabilities and public sector pension liabilities are particularly significant in size, with official estimates suggesting that the latter are larger than net debt itself. These estimates of public sector pension liabilities and future PFI payments total more than 63% of national income and are in

**Table 3.3. Estimated value of various future public sector obligations based on official estimates**

	£ billion	% of GDP
Public sector net debt, March 2007	500	36.8
Estimated public sector pension liabilities, March 2006	>725 <sup>a</sup>	>56
Estimated future PFI payments, signed current deals, November 2007	110	≈8
<b>Total</b>	n/a	<b>&gt;100</b>
<i>Other contingent liabilities</i>		
Network Rail debt, 30 September 2007	0 to 18	0 to 1.3
Support for Northern Rock PLC:		
Treasury support for Bank of England loan	0 to ≈24	0 to ≈1.7
Treasury support for all other lenders	0 to ≈31	0 to ≈2.2
Treasury having control of all other liabilities (net of short-term financial assets)	0 to ≈45	0 to ≈3.2
<i>(Less potential contingent assets (apart from short-term financial assets))</i>	<i>(≈−100 to 0)</i>	<i>(≈−7.5 to 0)</i>

<sup>a</sup> Estimate of public sector pension liabilities is the unfunded liabilities of the Teachers' Pensions Scheme (England and Wales), Principal Civil Service Pension Scheme, Armed Forces Pension Scheme, UKAEA Pension Schemes, DfID: Overseas Superannuation, Police Pension Schemes, Firefighters Pension Schemes and the National Health Service Pension Scheme. These come to £725 billion. Since the liabilities of other, albeit relatively smaller, schemes are excluded, the total unfunded liabilities will be greater than this.

Sources: Public sector net debt from table A4 of HM Treasury, *Public Sector Finances Databank*, December 2007 ([http://www.hm-treasury.gov.uk/media/B/2/pfd\\_211207.xls](http://www.hm-treasury.gov.uk/media/B/2/pfd_211207.xls)). Public sector pension liabilities from Parliamentary Scrutiny Unit, *Public Sector Pensions*, Briefing Note, May 2007 (<http://www.parliament.uk/documents/upload/publicsectorpensions.pdf>) and page 26 of *NHS Pension Scheme and NHS Compensation for Premature Retirement Scheme: Resource Accounts 2006–07*, November 2007 (<http://www.official-documents.gov.uk/document/hc0607/hc10/1007/1007.pdf>). Estimated future PFI payments from table 18 of HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review: The Economy and Public Finances – Supplementary Charts and Tables*, October 2007 ([http://www.hm-treasury.gov.uk/media/2/B/pbr\\_csr07\\_economy907.pdf](http://www.hm-treasury.gov.uk/media/2/B/pbr_csr07_economy907.pdf)) with payments discounted to 2007–08 by future nominal national income (assuming real growth of 2½% p.a. and economy-wide inflation of 2.7% p.a. from April 2013 onwards). Network Rail debt from table 9, page 22 of Network Rail Infrastructure Limited, *Interim Financial Statements: Six Months Ended 30 September 2007* (<http://www.networkrailmediacentre.co.uk/Content/detail.asp?ReleaseID=3453&NewsAreaID=2&zip=True>). Figures for Northern Rock's liabilities and assets from its latest annual report and interim report (<http://companyinfo.northernrock.co.uk/investorRelations/results/>). Statements from HM Treasury, the Bank of England and the Financial Services Authority regarding Northern Rock can be found at <http://www.bankofengland.co.uk/publications/northernrock/index.htm>.

total 60% larger than PSND itself. This gives an estimate of total liabilities of the public sector from these three sources exceeding 100% of national income. In contrast, the two contingent liabilities relating to Network Rail and Northern Rock PLC shown in Table 3.3 are, at least relative to official PSND, small.

A number of issues arise with each of these components of the indebtedness of the public sector, and we now discuss each in turn.

### ***Public sector pensions (estimated liabilities in excess of £725 billion, March 2006)***

The future liabilities of unfunded public sector workers' pension schemes are not included in public sector net debt. Estimating the value of these liabilities is extremely difficult as it will depend on individuals' pension tenure, their final salaries, how their pension benefits are indexed and the longevity of public sector workers. Nonetheless, these liabilities appear to be substantial: the most recent official estimate of total liabilities is that at March 2005 they were worth £530 billion.<sup>27</sup>

The government has not, as yet, published its estimate for total unfunded pension liabilities at March 2006, despite Andy Burnham, the Chief Secretary to the Treasury, stating in September 2007 that 'a new estimate will be published in the autumn'.<sup>28</sup> However, while the government has not been able to provide an update for these numbers, in May 2007 the Parliamentary Scrutiny Unit published a report that sets out the liabilities of the main unfunded pension schemes for March 2006, apart from the NHS, while the NHS accounts were published in November 2007.<sup>29</sup> In total, the liabilities of these main public sector schemes are estimated to be £725 billion, a very large increase on the March 2005 estimate of £530 billion, and one that is likely to be an underestimate given that the liabilities of some smaller pension schemes are not included in this figure.

Any estimate of the value of the future payments of pensions to public sector workers is extremely sensitive to how future payments are discounted. This in part explains the increase between March 2005 and March 2006 from £530 billion to £725 billion, since the former were based on a discount rate of 3.5% per year whereas the latter are based on a lower rate of 2.8% per year. These rates were chosen on the basis of Treasury guidance, which states that the rate of return on AA corporate bond should be used. As a result, for 2006–07 the discount rate is set to fall to just 1.8% per year, which will lead to a further significant increase in estimated liabilities. Estimates of the liabilities of the NHS pension scheme using the discount rate of 1.8% have already been published. These suggest that between March 2006 and March 2007, the estimated liabilities of the NHS pension scheme increased from £165.4 billion to £218.0 billion. Of this increase of £52.6 billion, the majority (£40.6 billion)

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<sup>27</sup> Latest official estimate by the Government Actuary's Department, mentioned in HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 ([http://www.hm-treasury.gov.uk/media/6/0/pbr06\\_longtermpublicfinancereport\\_476.pdf](http://www.hm-treasury.gov.uk/media/6/0/pbr06_longtermpublicfinancereport_476.pdf)).

<sup>28</sup> Source: Hansard, 10 September 2007, column 1980W (<http://www.publications.parliament.uk/pa/cm200607/cmhansrd/cm070910/text/70910w0021.htm>).

<sup>29</sup> Sources: Parliamentary Scrutiny Unit, *Public Sector Pensions*, Briefing Note, May 2007 (<http://www.parliament.uk/documents/upload/publicsectorpensions.pdf>) and page 26 of *NHS Pension Scheme and NHS Compensation for Premature Retirement Scheme: Resource Accounts 2006–07*, November 2007 (<http://www.official-documents.gov.uk/document/hc0607/hc10/1007/1007.pdf>).

is due to the reduction in the discount rate used. This highlights the fact that applying this lower discount rate to all public sector pension schemes will increase the estimated total liabilities significantly. However, given that the state can use future national income to cover its liabilities, it would seem more appropriate to deflate by expected economic growth, which would be around 2½% a year and, since it is below 2.8%, would still increase the estimated liabilities further above £725 billion, but not as far as is set to occur for 2006–07 when the discount rate will be reduced to just 1.8% per year. Other studies have proposed using the discount rate implied by government bonds, which is currently even lower than 1.8% and would increase the estimated liability even further.<sup>30</sup>

One key difference between public sector pension liabilities and public sector net debt is that governments are able to reduce the generosity of the future accrual of public sector workers' pension rights. However, such a change could have implications for other components of the remuneration package required to attract and retain public sector workers of the desired quality and motivation. This is discussed in detail in Chapter 8, and in particular in Section 8.4.

The treatment of public sector pensions also deserves more thought under the golden rule. On grounds of intergenerational fairness, it seems reasonable that today's taxpayers should pick up the tab for the future pension costs of workers employed to deliver current services today. Leaving aside the liability for longevity and other risks, this would happen automatically if public sector pension schemes were funded rather than pay-as-you-go. As most schemes in reality are not, the notable exception being the scheme for local government workers, it seems reasonable that if the government increases the number of public sector workers (or increases their expected pension tenures or expected final salaries, both of which would increase the expected value of their final salary pension arrangements), it should run a current budget surplus on average so that the increased cost of pension payments faced by tomorrow's taxpayers is offset by lower debt interest payments.

Of course, in thinking about whether and how to set such a target, we have to remember that we are not starting with a blank sheet of paper – today's taxpayers are already paying the pensions of past public sector workers despite potentially receiving little or no services from them. On these grounds, it might be thought reasonable to pass a similar burden onto future generations. So while it is true that today's public sector pension commitments were estimated by the Treasury in December 2006 to cost 2.0% of national income in 2055–56, past public sector pension commitments were already costing 1.5% of national income in

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<sup>30</sup> Deflating by expected GDP growth was proposed by J. Hawksworth, *Public Service Pension Liabilities and the Fiscal Rules*, PriceWaterhouseCoopers, London, 2006. Alternative estimates for public sector liabilities have made less optimistic (in terms of pension liabilities) assumptions over mortality improvements, salary growth and also the discount rate. For example, estimates produced by Neil Record and by Stephen Yeo are that the liabilities stand at £1,025 billion and £960 billion respectively. The largest component of the difference between these estimates and those of the Government Actuary's Department is the chosen discount rate. See N. Record, *Sir Humphrey's Legacy: Facing Up to the Cost of Public Sector Pensions*, Institute of Economic Affairs, 2006 (<http://www.iea.org.uk/files/upld-release114pdf?.pdf>), and S. Yeo, 'Unfunded public sector pension liabilities now close to £1,000 billion', Watson Wyatt Press Release, 8 March 2006 (<http://www.watsonwyatt.com/news/press.asp?ID=15784>).

2005–06.<sup>31</sup> It is the increase in the servicing burden over time that implies an additional intergenerational transfer, not the total debt burden.

Returning to the justification for the sustainable investment rule, we should presumably favour targeting a measure of public sector liabilities that reflects the expected impact of policy commitments made today on the revenue needs of governments tomorrow – not least because this is what investors in government debt will ultimately worry about. That suggests that, rather than ignore commitments where the precise timing and amount of the revenue required in the future are uncertain, we should instead take explicit account of the uncertainties in deciding what obligations it is safe to undertake. The completion of the Whole of Government Accounts<sup>32</sup> would be a good opportunity for the incoming Chancellor to think about widening the scope of the existing sustainable investment rule at least to include provisions (including public sector pensions), and possibly also to include the expected cost of contingent liabilities.

### ***Private Finance Initiative (future payments totalling £110 billion, November 2007)***

Under PFI arrangements, private firms undertake some capital spending on behalf of the public sector, with the public sector paying private firms a rental price for use of a capital asset, in addition to payments for any current goods and services, that the private sector delivers. While the use of the PFI began in 1987 (with the Queen Elizabeth II Bridge built over the Thames at Dartford/Thurrock), it has been much more widely used since Labour came to power.<sup>33</sup>

In total, PFI deals signed up to November 2007 that are still current are set to finance a total of £56.9 billion (4.1% of national income in 2007–08) of capital spending. Of this, 43% (£24.4 billion) is scored on the public sector balance sheet, with the remaining 57% (£32.5 billion) not on the public sector balance sheet.<sup>34</sup>

The total £56.9 billion will only be incorporated in public sector net debt to the extent to which payments have already been made by the public sector to the private sector, or where debt has been undertaken by the private sector under PFI and accountants judge (and the National Audit Office agrees) that the public sector has taken on the risks and rewards of owning the asset concerned (e.g. a hospital) and where the new asset – or a phase of improvement work on an existing asset – is operational.

Therefore, in the short run, a conventionally financed investment project would typically add more to public sector net debt than a project financed via PFI or public–private partnerships

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<sup>31</sup> Source: Table 5.1, page 40 of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 ([http://www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr06/assoc\\_docs/prebud\\_pbr06\\_adlongterm.cfm](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adlongterm.cfm)).

<sup>32</sup> For more information, see <http://www.wga.gov.uk>.

<sup>33</sup> Capital spending financed through the PFI averaged 0.1% of national income a year under deals signed over the 10-year period from 1987 to 1996, but averaged 0.5% a year over deals signed during the 11 years from 1997 to 2007 (with the three London Underground Tube deals being particularly significant in terms of the contracted capital spend (£17.6 billion, 1.3% of 2007–08 national income). Source: [http://www.hm-treasury.gov.uk/media/B/E/pfi\\_signeddeals\\_231007.xls](http://www.hm-treasury.gov.uk/media/B/E/pfi_signeddeals_231007.xls).

<sup>34</sup> HM Treasury, PFI Signed Projects List – October 2007, ([http://www.hm-treasury.gov.uk/documents/public\\_private\\_partnerships/ppp\\_pfi\\_stats.cfm](http://www.hm-treasury.gov.uk/documents/public_private_partnerships/ppp_pfi_stats.cfm)).

(PPPs). As long as this remains the case, there may be a suspicion that investment projects are undertaken via PFI (rather than conventionally) to help meet the sustainable investment rule rather than on value-for-money grounds. Had conventional finance been used instead of the PFI, then public sector net debt would have been increased by the total amount of capital spending that has taken place under the PFI so far (which will be less than the £56.9 billion that is set to be done eventually from all current contracts signed to date). Instead, the only amounts that have so far been included in public sector net debt are the payments that have so far been made to PFI providers (which as of March 2007 had totalled £20.6 billion across all PFI deals apart from those by the Scottish Government, from which data have not been made publicly available<sup>35</sup>) and the finance lease component (which in September 2006 was estimated by the ONS to have totalled £4.95 billion up to March 2006).<sup>36</sup>

Under a no-PFI scenario, public sector net debt – in the absence of compensating changes to taxes or other spending – would therefore have been much closer to, but not yet above, the 40% of national income level. Just as recent years have seen a greater proportion of PFI commitments included in net debt, this pattern is set to continue in April 2008 with the adoption of International Financial Reporting Standards which could affect the classification of the £32.5 billion of capital spending financed through PFI arrangements that are not currently on the public sector balance sheet.<sup>37</sup> Any significant classification change that increased public sector net debt could quite plausibly result in it being pushed above 40% of national income. However, Mr Darling might reasonably argue that if he had not intended to use the PFI then Mr Brown would have set the ceiling higher.

The future indebtedness of the public sector relates not to the capital value of PFI deals, but instead to the value of the payments that have been agreed contractually. In total, under deals signed up to November 2007, the value of future payments under current PFI contracts is £110 billion (after discounting future payments by assumed growth in national income). However, one key difference between these payments and the amounts owed to the holders of national debt is that in many cases these payments are in return for the receipt of future delivery of public service provision. This was acknowledged in a recent Treasury report on PFI policy, which stated that ‘In a typical PFI hospital, payments for services make up 40 to 50 per cent of the unitary charge [total payments to PFI providers]. For a typical PFI schools project, around 30 per cent of the unitary charge goes toward caretaking, maintenance and other services’.<sup>38</sup> Therefore a future government might well be able to negotiate a lower

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<sup>35</sup> HM Treasury, PFI Signed Projects List – October 2007’, ([http://www.hm-treasury.gov.uk/documents/public\\_private\\_partnerships/ppp\\_pfi\\_stats.cfm](http://www.hm-treasury.gov.uk/documents/public_private_partnerships/ppp_pfi_stats.cfm)).

<sup>36</sup> For a discussion of the finance lease component of PFI deals, see A. Chesson and F. Maitland-Smith, ‘Including finance lease liabilities in public sector net debt: PFI & other’, *Economic Trends*, November 2006, 636: 27–42 ([http://www.statistics.gov.uk/articles/economic\\_trends/ET636Chesson&MaitlandSmith.pdf](http://www.statistics.gov.uk/articles/economic_trends/ET636Chesson&MaitlandSmith.pdf)).

<sup>37</sup> See ‘Time to set the PFI record straight’, *Financial Times*, 27 July 2007 (<http://search.ft.com/ftArticle?queryText=pfi+net+debt+IFRS&y=0&aje=false&x=0&id=070727000705&ct=0>) and evidence from Nick Macpherson, Permanent Secretary of HM Treasury, to the House of Commons Treasury Select Committee, 14 November 2007 (specifically, responses to questions 65 to 67) (<http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/uc57-i/uc5702.htm>).

<sup>38</sup> Paragraph 2.25, page 22 of HM Treasury (2006), *PFI: Strengthening Long-Term Partnerships*, March 2006 ([http://www.hm-treasury.gov.uk/media/7/F/bud06\\_pfi\\_618.pdf](http://www.hm-treasury.gov.uk/media/7/F/bud06_pfi_618.pdf)).

payment from the public purse in return for a reduction in services provided, in particular where these are for current rather than capital goods.

***Network Rail (net debt up to £18 billion, September 2007)***

Borrowing carried out by Network Rail could be considered similar to conventional government borrowing as the government guarantees to repay its debt if the company collapses, though the Office for National Statistics defines it as a private sector company and therefore off the public sector's balance sheet. In order to avoid a collapse, if the company got into serious trouble it is likely that the government would take greater control and the ONS would reclassify it as part of the public sector for the purposes of the National Accounts, even if Network Rail had not been formally renationalised. Such a reclassification would further reduce the Chancellor's room for manoeuvre in remaining below the current debt ceiling.

***Northern Rock (liabilities up to £100 billion, January 2008)***

The Treasury has underwritten a loan from the Bank of England to Northern Rock PLC for around £25 billion. In addition, the Treasury has also guaranteed other creditors – estimated at around £30 billion – to Northern Rock which ensures that savings deposited at Northern Rock remain risk-free from the point of view of savers. If a private sector takeover that was acceptable to the Treasury were to take place of Northern Rock, then it would allow the new owner to issue bonds, the repayment of which (including interest) would be underwritten by the taxpayer, in order to repay in full the loan (and interest) to the Bank of England and also to provide some working capital for the operation of the business.<sup>39</sup> The total potential exposure to the taxpayer could remain at around £55 billion (or 4% of national income).

The ONS could decide that the government has sufficient power to control Northern Rock and that it should be treated as part of the public sector in the national accounts. This would be the case were Northern Rock brought into temporary public ownership, which is what the Treasury has said will happen if an acceptable private sector sale is not made. This would bring both Northern Rock's liabilities and its assets (each valued at around £113 billion<sup>40</sup>) onto the public sector balance sheet. The impact on public sector net debt would be to add Northern Rock's liabilities (£113 billion) to net debt less any short-term financial assets (£13 billion) that it held. The net addition of around £100 billion would increase the debt ratio from its current 37.7% of GDP to around 45%. But the impact on net debt would eventually be mitigated by the sale of any of Northern Rock's long-term financial assets. We would therefore expect the long-term impact on net debt – which is what should matter for fiscal policy decisions – to be much less than £100 billion. It might even reduce, rather than increase, net debt.

However, whether or not the ONS decides that the taxpayer guarantees for Northern Rock's borrowing should be included in net debt does not affect in any way the true exposure of taxpayers. Therefore the fact that net debt might well be pushed significantly above 40% of national income should not affect the approach the government takes. The government should

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<sup>39</sup> Statements from HM Treasury, the Bank of England and the Financial Services Authority regarding Northern Rock can be found at <http://www.bankofengland.co.uk/publications/northernrock/index.htm>.

<sup>40</sup> <http://companyinfo.northernrock.co.uk/investorRelations/results/stockEx070725.asp>.

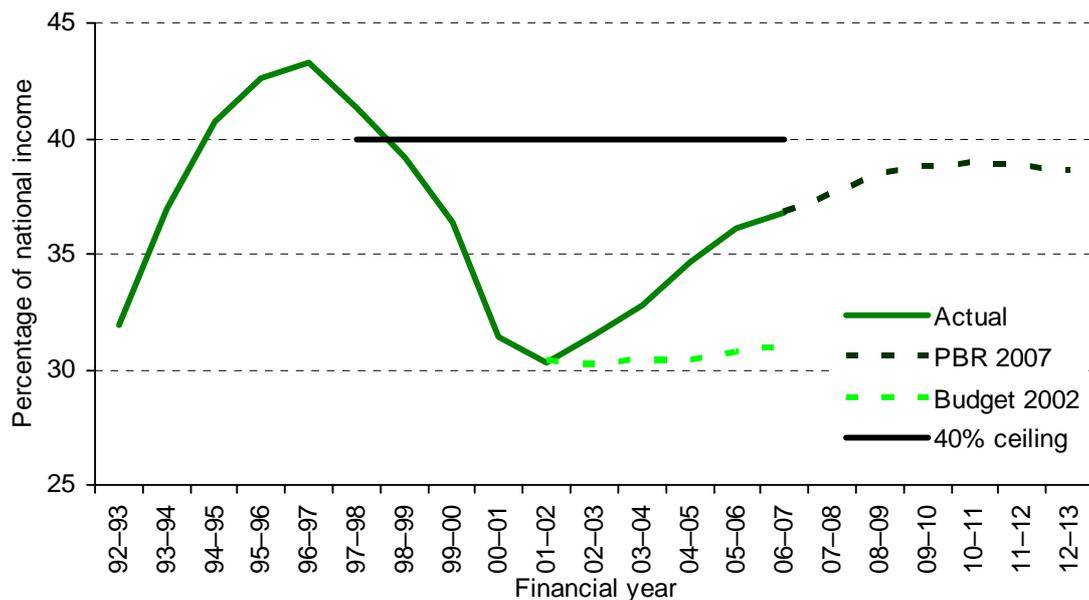
make the right decision for taxpayers and the long-term strength and stability of the banking system.

Regardless of any ONS decision, it would be sensible and desirable for the Treasury to publish measures of borrowing and debt that include and exclude the impact of commitments made to Northern Rock. This would aid analysis of both the underlying position of the public finances (excluding the impact of Northern Rock, which the government believes will be temporary) and the total commitments of taxpayers (including those made to Northern Rock).

### The sustainable investment rule in practice

The same errors that have required the Chancellor to increase his forecasts of public sector borrowing repeatedly since 2001 (see Section 3.2) have also required him to increase his forecasts for public sector net debt. As Figure 3.7 shows, this has brought debt much closer to 40% of national income than it was forecast to be back in the Budget of 2002. But the Treasury has only promised to keep the ratio below 40% in every year of the economic cycle that began in 1997–98 and that the Treasury thinks ended in 2006–07. So we do not know yet whether the same will apply during the new cycle.

Figure 3.7. Treasury public sector net debt forecasts



Sources: Various Budgets and Pre-Budget Reports.

Table 3.4. Meeting the sustainable investment rule?

Financial year	Central estimate for net debt in PBR 2007	Probability net debt exceeds 40%
2008–09	38.4%	8%
2009–10	38.8%	33%
2010–11	38.9%	41%
2011–12	38.8%	44%

Note: As Figure 2.10.

Sources: As Figure 2.8.

Applying the probability distribution implied by past Treasury forecasting performance to its central estimate in the Pre-Budget Report (see Section 2.6), we can derive the probabilities that net debt would, on unchanged policies, breach 40% of national income in each of the next four years. These are shown in Table 3.4. Unless the Chancellor relaxes the sustainable investment rule in the next cycle, the Treasury's own forecasting abilities give him a less than 60% chance of sticking to it (without further spending cuts or tax increases) based on past performance. This suggests that the sustainable investment rule may now be more binding than the golden rule.

### 3.4 Reforming the rules: a golden opportunity?

As Chancellor, Gordon Brown transformed the machinery of macroeconomic policymaking in the UK – by giving the Bank of England control of interest rates in pursuit of an inflation target and by setting himself two high-profile pass/fail tests for fiscal policy in the shape of the golden rule and the sustainable investment rule. The introduction of the independent MPC and the associated reforms to the setting of interest rates are widely regarded as a triumph, while his fiscal reforms are regarded with scepticism at best and cynicism at worst.

Judging from the inflation expectations implicit in gilts prices, Gordon Brown's monetary policy framework has convinced financial market participants that interest rates will be driven by the inflation target rather than by short-term political considerations. When it comes to fiscal policy, we do not have an objective measure of the credibility of the rules analogous to financial market inflation expectations. When government borrowing (and the supply of gilts) is expected to increase, we might expect the yield on government debt to increase as well and fulfil a similar function. But, as discussed in Chapter 4, other factors are at play and the relationship between the amounts industrial country governments borrow and the interest rates they pay has not been particularly close in recent years.

Many economists outside government have little faith in the rules as a decisive factor determining the government's tax and spending decisions. In its 2007 New Year survey of the views of independent economists, the *Financial Times* concluded that 'Almost none use the chancellor's fiscal rules any more as an indication of the health of the public finances'.<sup>41</sup>

This probably reflects the belief that Mr Brown 'moved the goalposts' as downward revisions to his public finance forecasts eroded the margin by which he expected to meet the rules after 2001. Suspicions were raised initially when he changed the way in which he calculated the cumulative current budget surplus over the cycle in a way that gave a more flattering picture (although the Treasury claimed that the less flattering method was only a 'shorthand' for use in speeches). The most controversial decision was to add two years, during which there had been on average a net current budget surplus, to the beginning of the economic cycle at precisely the point when it appeared necessary to get the government back on course to meet the golden rule. Mr Brown's decision to delay repeatedly the announcement of a fiscal tightening that most independent observers thought necessary until just after the 2005 election has also suggested that the rules have not depoliticised budget judgements to anything like the

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<sup>41</sup> 'Cut spending to reduce borrowing', *Financial Times*, 2 January 2007 (<http://www.ft.com/cms/s/683400d2-9a05-11db-8b6d-0000779e2340.html>).

degree that the monetary policy framework has depoliticised interest rate decisions. The Treasury's current reluctance to say whether the year in which the current economic cycle ends will also be counted as the first in the next cycle (which would be consistent with past practice, but would mean this current cycle beginning with the current budget in deficit by 0.4% of national income) and the fact that it is yet to confirm whether the sustainable investment rule target will remain to keep net debt below 40% in each and every year of the new economic cycle, as it was in the last, risks further accusations of goalpost-moving.

On the face of it, this seems like a lot of fuss over nothing. As we saw in Section 3.2, the golden rule is at best a rule of thumb and there is little direct economic significance if it is met or missed by a few billion pounds either way. It can also be argued that the rules have acted as a constraint on tax and spending decisions – as shown in Figure 2.2, the Spring 2005 Budget contained net tax-raising measures despite being a pre-election Budget, presumably at least in part because (as discussed in Section 3.2) the outlook for the public finances had almost eliminated the margin with which the golden rule was expected to be met.

The reason that these issues have taken on such importance is that from the outset, Mr Brown staked his credibility on achieving the rules exactly, creating conditions in which meeting them by £1 would be a political triumph and missing them by £1 a disaster. This approach did not look very risky four or five years ago, when the rules were expected to be met with tens of billions of pounds to spare. But he fell victim to the characteristic serial correlation of the Treasury's fiscal forecasting errors: things turned out better than expected early in the cycle, and Mr Brown used the proceeds to top up his spending plans; when the forecasts took a turn for the worse, his room for manoeuvre evaporated and time ran out to take countervailing measures. It is between Mr Brown and his conscience whether he actually instructed the Treasury to add two years to the beginning of the cycle primarily because it appeared necessary to meet the golden rule. However, there is a widespread suspicion that he did and that he has preferred to affront fiscal aficionados by moving the goalposts in a way that will be obscure to the general public, rather than read headlines saying the rule has been broken. This suspicion has eroded credibility.

Whatever the reality, if the Treasury sticks with its current dates for the cycle, then the golden rule has been met. This may leave close observers of the fiscal goalposts unimpressed, but the combination of this opportunity to declare 'victory' and Mr Darling's first Budget as Chancellor may be a golden opportunity to tweak the fiscal framework for the better. This could legitimately be presented as adhering to the spirit of Mr Brown's original vision, and indeed could be said to apply lessons learned from the widely hailed success of his monetary policy regime.

If so, what should be done?

- First, it seems reasonable to stick with the golden rule and sustainable investment rule as rules of thumb, but they should be presented as such rather than as an exact science. In relation to the golden rule, Mr Darling might ponder a more sophisticated distinction between spending that does and does not benefit future taxpayers, but the benefits of abandoning the familiar National Accounts distinction between current and capital spending may well not exceed the costs in terms of transparency and predictability. In relation to the sustainable investment rule, it may be worthwhile rethinking the treatment of public sector pension liabilities, using the introduction of Whole of Government

Accounts to widen the range of obligations to which the sustainable investment rule applies. It may also be worthwhile to require today's taxpayers to finance the difference between the future costs of public sector pension commitments that arise simply because they wish to consume greater public services today and the public sector pensions being paid by today's taxpayers for services delivered to previous generations. A difficulty arises from the uncertainty around these commitments. To the extent to which these arise as a result of changes in the assumed discount rate, then, as noted in Section 3.3, this could be set to be equal to expected growth in national income, which might be both more appropriate and more stable than the current method of using particular market rates of return. This might still require either the debt ceiling to be changed or an appropriate period of adjustment to be allowed, were significant information to come to light such as revisions to longevity assumptions. This flexibility would then potentially come at the cost of transparency.

- Second, like the inflation target, the golden rule should be made symmetric, requiring the government to pursue a point target for the current budget balance rather than 'balance or surplus'. Symmetry seems a more appropriate way to pursue intergenerational fairness, and it also avoids the problem of the Chancellor needing to decide – implicitly or explicitly – what safety margin to aim for to give an acceptable probability of falling the right side of the pass/fail line.
- Third, the Treasury should present its forecasts for the fiscal aggregates in such a way that they explicitly quantify the uncertainties around the central estimate – for example, with a 'fan chart' similar to that which the Bank places around its inflation target. The baseline forecast should also be a genuinely 'central' forecast, rather than one based on 'cautious' economic assumptions that inject deliberate bias.
- Fourth, the Treasury should no longer seek to meet the golden rule over a specific dated economic cycle. Instead, it should say that it is aiming for a target level for the total or cyclically adjusted current budget balance over an appropriate time horizon. (The former has the added attraction of avoiding the need to calculate an estimate of the output gap, which may be suspected of political manipulation.) It can be argued that the Treasury has in effect been doing this implicitly in recent years, with a rolling target (now being missed) to achieve a current budget surplus of around  $\frac{3}{4}\%$  of national income after five years.

One problem with operationalising such an approach is that the Treasury's forecasts for tax revenue typically include an automatic tightening of around  $\frac{3}{4}\%$  of national income over a five-year time horizon as a result of 'fiscal drag'. This means that the government could run a current budget deficit every year of  $\frac{3}{4}\%$  of national income, by giving away the proceeds of fiscal drag in tax cuts or higher spending each year, and assert that it is on course to achieve a current budget balance in five years' time on 'unchanged policies'. This strengthens the case, which is already strong on transparency grounds, for changing the definition of unchanged policy to one in which income tax and National Insurance thresholds are assumed to rise in line with average earnings (or alternatively the projected growth in their underlying tax base) rather than prices. A similar, but quantitatively less important, case could be made for other taxes (such as stamp duty land tax and inheritance tax) in which the tax base is expected to grow in real terms over time.

Successive Chancellors have found it convenient to exploit fiscal drag as a ‘stealth tax’, so such a change is unlikely to find favour with the Treasury.

The use of a fixed, dated cycle means that policy is unnecessarily and unhelpfully backward-looking, with tax and spending decisions today in principle depending on past policy and forecast errors and on changing assessments of the start date of the cycle, rather than on the most appropriate path looking forward. It is also worth bearing in mind that Mr Brown’s Chancellorship was unusually long: he and Dennis Healey were the only Chancellors in the last half a century to have served for a full economic cycle.

- Fifth, if possible, an independent body or bodies should be given access to the same information on the evolution of spending and tax revenues that the Treasury receives to make forecasts of fiscal aggregates. The Treasury has long argued that this would be impossible, and there are certainly serious legal issues of taxpayer confidentiality that would need to be addressed. However, it would be helpful for the Treasury or for the Treasury Select Committee to ask former senior officials of the Treasury and HM Revenue & Customs to assess independently whether this would be possible and how it might be achieved. One model would be for an official forecasting body to be responsible to Parliament rather than to Ministers. The Treasury might even agree to abide by the net fiscal policy adjustment recommended by this body to achieve the fiscal targets that would appropriately still be set by the government.

The argument is not that reforms of this sort would necessarily produce more accurate forecasts, but that it would reassure voters and investors that the forecasts were not being massaged to delay politically inconvenient policy adjustments. This would also leave the choice of individual tax and spending decisions – and the political trade-offs they involve – with Ministers, where they belong. At the very least, the Treasury could continue to enhance transparency further by publishing a more in-depth explanation of the assumptions that underpin its revenue and spending projections.